MVCapital MANAGEMENT

MVCM Quarterly Newsletter

First Quarter Ended March 31, 2012

Rare Glimpse of the Old Normal

There was relatively little to complain about for the first three months of 2012. A significantly warmer than average winter had people out of doors in their spring clothing all up and down the Eastern Seaboard. The investment climate was similarly temperate and forgiving. The S&P 500 surged 12.6% on a total return basis for the quarter. Perhaps even more impressive than the number itself was the measured pace of the gains – steady gains of between three and four percent for each month of the quarter. Daily price gyrations were a tame fraction of the massive lurches to which we had become accustomed over the course of the latter half of 2011. For one quarter, anyway, things seemed more like the "old normal" that held sway before 2008, rather than the fractious "new normal" that has defined the times since then.

Markets in Europe pulled back from the edge of the dark abyss. The sky-high borrowing costs that threatened to take down Italy and Spain retreated to manageable levels, while negotiators over Greece's seemingly intractable woes managed to stitch together the essentials of an agreement to keep that country technically out of default. The MSCI EAFE index gained 11% for the quarter with core and peripheral countries alike showing strong performance. While the financial pressures eased, though, the European economic picture did not brighten. Economists estimate that the continent is in a period of flat or slightly negative growth. The austerity programs that have been imposed on the Continent's economies will most likely exacerbate that trend in the near term.

Despite the solid performance across most categories of risk assets, market sentiment remained tentative. Perhaps the best indicator of this was the refusal of safe haven bond yields to stray upwards too much. The yield on the 10-year Treasury, which had been over 3.2% a year earlier, remained below 2% for much of the quarter, while other safe haven assets like gold and the Swiss franc remained firm as well. Investors may like the old normal, but not all are sure it will stay around.

Smooth Sailing or Eye of the Storm?

Indeed, right on cue to start the second quarter was the first significant pullback of 2012 (though still far from a technical correction as of this writing). The culprit? Many, no doubt, but "Spanish bond rates" was a phrase once again on everyone's lips, along with that the reappearance of volatile intraday mood swings. "Risk on / risk off" came back onto center stage.

To be sure, at 1380 the S&P 500 is a long way away from the 1100 level it grazed at the end of September last year. But EAFE lost over 5% in price terms between March 28 and April 17, with most of the downdraft coming from the beleaguered peripherals. It is worthwhile remembering two things. First, the fact of these markets stabilizing in the first quarter was a result of defusing the most pressing immediate default threats – not of fundamentally solving any of the underlying problems. Second, the austerity programs these countries have agreed to in exchange for bailout funds are going to hit economies that are already on their knees. The rate of unemployment in Spain is near 25%, roughly where it was at the height of the Great Depression, and the rate among young citizens of job age is reckoned to be over 50%, an unsustainable situation. If these economies are unable to grow organically then the austerity measures will more likely worsen, rather than improve, their ability to get out of the debt trap.

There are other concerns keeping investors awake at night, foremost among which is the durability of the US economic recovery. That stocks are higher is not surprising given where US corporate profits are – at historical highs. Surging profits are responsible for a modest twelve month trailing P/E for the S&P 500 hovering in the mid-teens. On the other hand the Case-Shiller cyclically adjusted P/E ratio, taking into account inflation-adjusted earnings for the previous ten years, is around 22. Whether or not current earnings trends will prove sustainable is likely to be a major driver of performance over the near and intermediate term.

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